Cytonn Q3'2019 Markets Review

Fixed Income

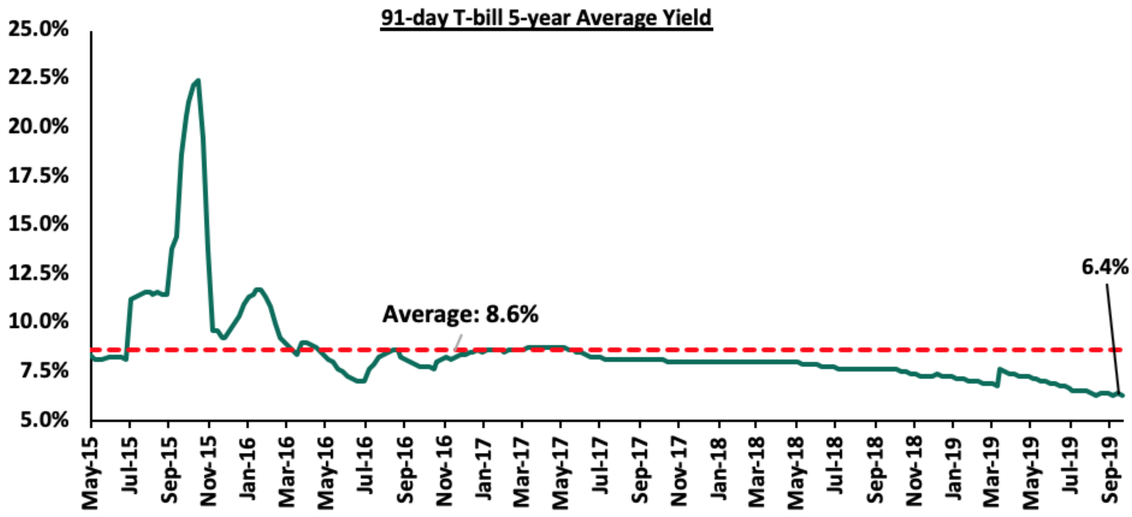
Money Markets, T-Bills & T-Bonds Primary Auction:

T-bills remained oversubscribed in Q3'2019, with the average subscription rate coming in at 106.8%, a decline compared to 125.5% in Q2'2019. Average subscription rates for the 91-day, 182-day, and 364-day papers in Q3'2019 came in at 121.9%, 44.4% and 163.0%, respectively, from 100.6%, 49.6% and 248.1% in Q2'2019. Yields on the 91-day and 182-day T-bills decreased by 0.4% points and 0.3% points, while that of the 364-day T-bill gained by 1.0% points in Q3'2019, closing at 6.3%, 7.2%, and 9.8%, from 6.7%, 7.5%, and 8.8% for the 91, 182, and 364-day papers, respectively, mainly due to the Central Bank of Kenya's (CBK's) efforts to keep rates low by rejecting expensive bids in the auction market.

During the week, T-bills were undersubscribed at a subscription rate of 86.4%, down from 98.4% recorded the previous week attributable to tight liquidity in the market owing to CBK's actions of mopping up of liquidity through offering attractive rates of about 8.9% on repurchase agreements (repos). The yields on the 182-day and 364-day papers remained unchanged at 7.2% and 9.8%, respectively, while the yield on the 91-day paper increased marginally to 6.4% from 6.3%, the previous week. The acceptance rate declined to 55.2% from 64.9% recorded the previous week, with the government accepting Kshs 15.3 bn of the Kshs 23.6 bn worth of bids received.

The yield on the 91-day T-bill is currently at 6.4%, below its 5-year average of 8.6%. The lower yield on the 91- day paper is mainly attributed to the low interest rate environment we have been experiencing, and we expect this to continue in the short-term because:

i. The rate cap is still in place, which will make it easier for the government to borrow from the domestic market, as institutions will continue channeling funds more actively towards government securities deemed less risky, since the pricing of loans to the private sector is based on the Central Bank Rate as opposed to their risk profiles, and,
ii. The government domestic borrowing requirement for the 2019/20 financial year has been reduced by 4.8%, to Kshs 305.7 bn from Kshs 321.0 bn, with revenues expected to increase by 14.2% from the previous fiscal year, to Kshs 2.1 tn from Kshs 1.9 tn.



During Q3'2019, the Kenyan Government issued 5 Treasury Bonds, with details in the table below:

No.	Date	Bond Auctioned	Effective Tenor to Maturity (Years)	Coupon	Amount to be Raised (Kshs bn)	Actual Amount Raised (Kshs bn)	Average Accepted Yield	Subscription Rate	Acceptance Rate
1	29/07/2019	FXD3/2019/15	15.0	12.3%	40.0	50.6	12.3%	216.7%	58.4%
2	19/08/2019	FXD3/2019/10	10.0	11.5%	50.0	45.0	11.5%	105.5%	85.3%
3	19/08/2019	FXD1/2019/20	20.0	12.9%		14.7	12.7%	29.3%	100.0%
4	23/09/2019	FXD1/2018/15 (Re-open)	15.0	12.7%	50.0	15.3	12.6%	30.5%	100.0%
5	23/09/2019	FXD2/2019/15	15.0	12.7%		17.4	12.7%	34.7%	100.0%
	Average							**83.3%**	**88.7%**

Performance in the Primary T-bond auctions in Q3'2019 was varied between the various issues, with the subscription rate averaging 83.4%. The average acceptance rate for Q3'2019 came in at 88.7%, as the CBK continued to reject bids deemed expensive in order to maintain the rates at low levels.

During the week, the CBK re-opened two T-bonds; FXD1/2018/15 and FXD2/2019/15 through a tap sale. The bonds were undersubscribed at an overall subscription rate of 31.2%. The yield came in at 12.6% for FXD1/2018/15 and 12.7% for FXD2/2019/15. The acceptance rate came in at 100.0%, meaning the government accepted all the bids received, which were worth Kshs 9.3 bn, against Kshs 30.0 bn on offer.

Green Bond

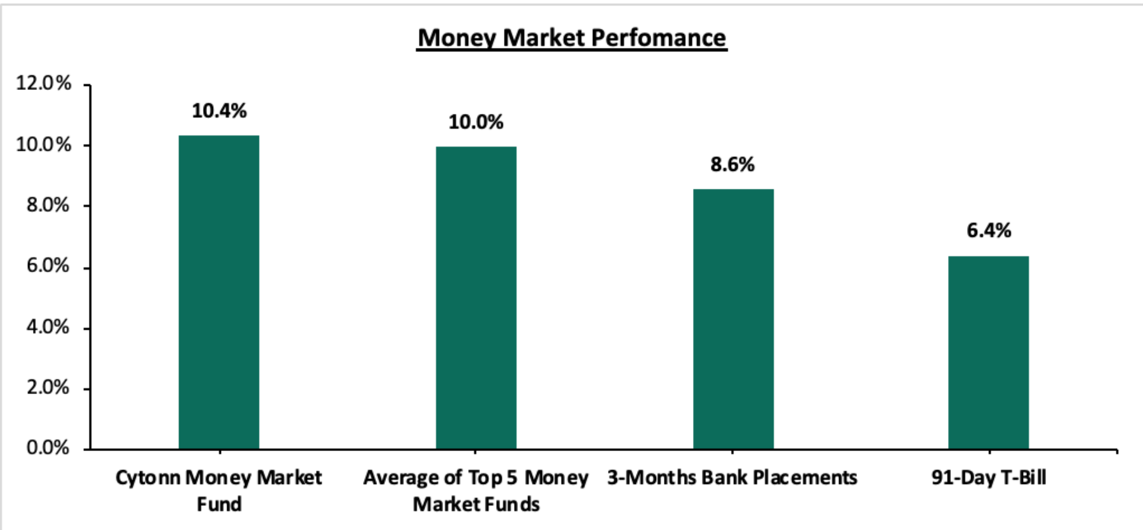
During the week, Acorn Group announced that the country's first ever green bond issued by the company, in partnership with PE Fund Helios, had attracted an 85.0% subscription rate, raising Kshs 4.3 bn of the targeted amount of Kshs 5.0 bn. The notes have been certified as 'Green Bonds' based on Acorn's compliance with Climate Bonds Standards through the Climate Bonds Standard Board, who approved the Pre-issuance Certificate of the bond. The criteria to meet the Climate Bonds Standard principles include water, energy and materials efficiency. Under water efficiency, an independent verifier will look at the use of low flow showerheads and faucets for kitchen sinks and wash basins. In terms of energy efficiency, the verifier will look at natural ventilation, smart meters and sensor lighting. For material efficiency, they will focus on materials used for floor slabs, roof slabs and aluminium window frames.

The bond was priced at a rate of 12.3%, and will be used to finance sustainable and climate-resilient student accommodation with a combined capacity of 40,000 beds. According to the company's CEO, Edward Kirathe, the first tranche of the medium-term note targeted to raise Kshs 2.0 bn given that the local bond market has not witnessed any corporate bond issue since 2017, attributable to defaults witnessed over the past five-years by issuers such as ARM Cement, Nakumatt and Imperial Bank. Contrary to expectations, the market has been receptive and the company attributes this to having GuarantCo as its guarantor, which sparked investor confidence. According to the company, the investor mix comprised mainly of pension funds, commercial banks, and development finance institutions accounting for 30.0% each, while insurance firms took up 10.0%. The lead arrangers of the issue, Stanbic Investment Bank, recommended that prospective issuers of bonds will have to enhance their credit risk profiles to be able to be successful, citing that it was important to outline the benefits, risk and engage early on a non-deal roadshow in order to spark interest.

According to report done by the IFC, a green bond is a fixed-income instrument whose distinguishing feature is that proceeds are earmarked exclusively for projects with environmental benefits. These include: renewable energy, adaptation to climate change, waste management, pollution prevention, water management and green buildings, just to name a few. The green bond market was launched in Kenya in February 2019, through the Green Bonds Programme Kenya, which is a joint initiative between the Central Bank of Kenya, Nairobi Securities Exchange, Climate Bonds Initiative and Kenya Bankers Association with several other organizations endorsing the program. Similar to infrastructure bonds, the instruments will be tax-free following changes in the proposed Finance Bill 2019 which is still going through the legislative process in parliament. In our view, the introduction of the green bond is a pro-active and good initiative by the Capital Markets Authority, which will benefit both investors and the stakeholders in the long-run considering its focus on environmental issues and a more sustainable economy.

Money Market Funds

In the money markets, 3-month bank placements ended the week at 8.6% (based on what we have been offered), the 91-day T-bill came in at 6.4%, while the average of Top 5 Money Market Funds by yield came in at 10.0%, unchanged from the previous week, with the Cytonn Money Market Fund closing the week at 10.4%.

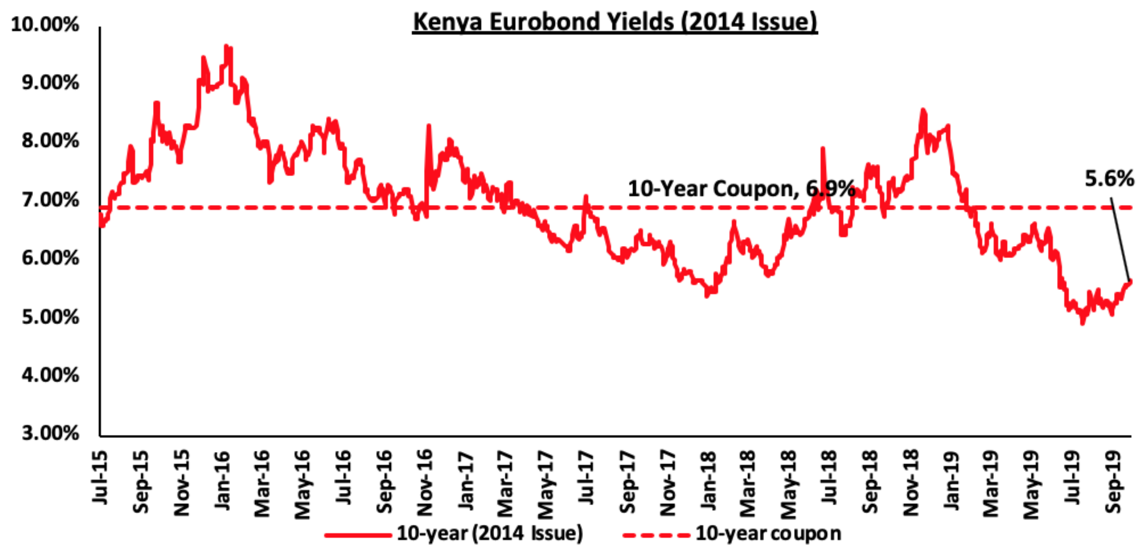


Liquidity

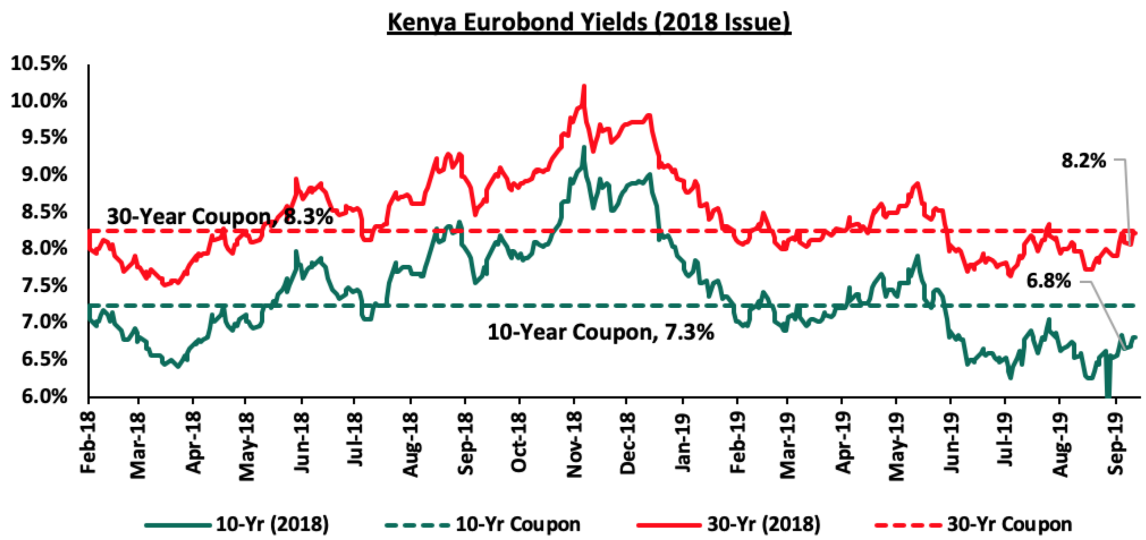
Liquidity tightened during Q3'2019 as indicated by an increase in the average interbank rate to 4.1%, from 3.7% recorded in H1'2019. During the week, liquidity tightened with the average interbank rate increasing to 7.5%, from 7.3% recorded the previous week, attributable to CBK's actions of mopping up of liquidity through offering attractive rates of about 8.9% on repurchase agreements (repos) which is posing stiff competition for smaller banks. This saw commercial banks' excess reserves increase to come in at Kshs 13.0 bn in relation to the 5.25% cash reserves requirement (CRR), from Kshs 14.4 bn the previous week. The average volumes traded in the interbank market decreased by 14.9% to Kshs 6.2 bn, from Kshs 7.3 bn the previous week.

Kenya Eurobonds:

The yields on the 10-Year Eurobond issued in 2014 have increased marginally by 0.1% points to 5.6%, from 5.5% seen in Q2'2019. The rise in Eurobond yields in the past four weeks has been attributable to news that global rating firm Moody's could further lower Kenya's creditworthiness currently at '*B2 stable*' following the completion of their periodic review on Kenya, where they raised concern over the country's very low fiscal strength, ballooning debt and rampant corruption.

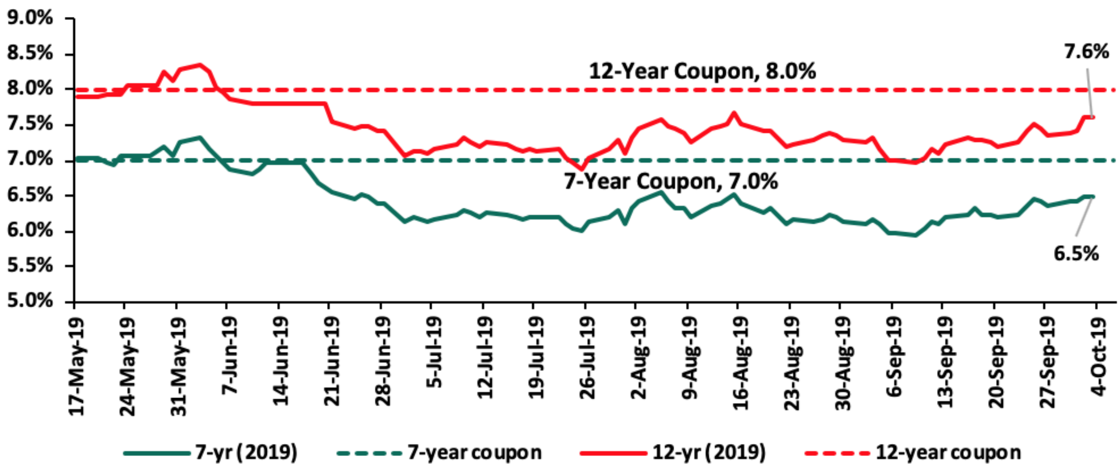


For the February 2018 Eurobond issue, since the issue date, yields on the 10-year Eurobond have decreased by 0.4% points to close Q3'2019 at 6.7% while the 30-year Eurobond has decreased by 0.2% points to close the quarter at 8.1%. During the week, the yields on the 10-year and 30-year Eurobond both increased by 0.1% points to 6.8% and 8.2%, from 6.7% and 8.1% recorded the previous week.



For the latest issued dual-tranche Eurobond during Q3'2019, with 7-years and 12-years tenor, priced at 7.0% for the 7-year tenor and 8.0% for the 12-year tenor, respectively; the yield on the 7-year bond gained by 0.1% points to 6.5% from 6.4% recorded in the previous week, while the 12-year bond gained by 0.2% points to 7.6% from 7.4% recorded in the previous week.

Kenya Eurobond Yields (2019 Issue)



Rates in the fixed income market have remained relatively stable as the government rejects expensive bids. The Government failed to meet its FY'2018/2019 domestic target narrowly by 1.3%, having borrowed Kshs 317.0 bn against a target of Kshs 321.0 bn. A budget deficit is likely to result from depressed revenue collection with the revenue target for FY'2019/2020 at Kshs 2.1 tn, creating uncertainty in the interest rate environment as additional borrowing from the domestic market goes to plug the deficit. Despite this, we do not expect upward pressure on interest rates due to increased demand for government securities, driven by improved liquidity in the market owing to the relatively high debt maturities. Our view is that investors should be biased towards medium-term fixed income instruments to reduce duration risk associated with long-term debt, coupled with the relatively flat yield curve on the long-end due to saturation of long-term bonds.